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| In the Matter of | |
| 1998 Biennial Regulatory Review – Reform of the International Settlements Policy and Associated Filing Requirements | IB Docket No. 98-148 |
| Regulation of International Accounting Rates | CC Docket No. 90-337 |

# REPLY COMMENTS OF SBC COMMUNICATIONS INC.

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## REPLY COMMENTS OF SBC COMMUNICATIONS INC.

SBC Communications Inc. ("SBC") respectfully submits this reply to the comments filed in the above-referenced docket.

### I. INTRODUCTION AND SUMMARY

A great majority of the commenting parties join SBC in supporting the important deregulatory measures the Commission proposes. There is virtually unanimous support for the Commission's stated goal of substituting competition and market-driven arrangements for the strictures of the International Settlements Policy ("ISP") and related regulations wherever feasible.

While some parties criticize the Commission for not going far enough in removing the ISP, the major complaints about the Commission's proposals come, not unexpectedly, from the large IXCs, especially AT&T and MCI. These two carriers, which together account for more than 85% of international service revenues, have an obvious interest in preserving the status quo. While they profess support for moving to a more deregulatory environment, they argue for various modifications, limitations and conditions on the Commission's proposals that, if adopted, would undermine many of the pro-competitive benefits the Commission seeks to achieve.

By contrast, the Commission's straightforward deregulatory proposals to lift the ISP for arrangements with foreign carriers without market power and on routes on which ISR is permitted are broadly supported by new entrants in the international services market, including Bell Companies (such as SBC) and small interexchange carriers and their representatives (such as Comptel and Qwest).

This unusual alliance is telling: what BOCs and smaller IXCs have in common in this proceeding is a need to be able to enter the highly concentrated international services marketplace and compete effectively against the established carriers. In other contexts, the Commission is often faced with new entrants seeking regulatory protections and established incumbents seeking regulatory relief. Here, however, the situation is reversed, which underscores the validity of the Commission's tentative conclusion that in the rapidly changing post-WTO telecommunications environment, the ISP has become often more of an impediment, than an aid, to the development of competition in international services.

## II. THE INTERNATIONAL SETTLEMENTS POLICY

### A. THE COMMISSION SHOULD ADOPT ITS PROPOSAL NOT TO APPLY THE ISP AND RELATED FILING REQUIREMENTS TO ARRANGEMENTS WITH FOREIGN CARRIERS LACKING MARKET POWER IN WTO MEMBER COUNTRIES.

Virtually all parties agree with the Commission's proposal to lift the ISP for arrangements with foreign carriers lacking market power in WTO Member countries. Several commenters, however, seek to undermine the pro-competitive benefits of lifting the ISP by restricting its implementation. For instance, AT&T argues that the question of whether a foreign carrier has market power in any given country must be determined by the Commission on a case-by-case basis after full opportunity to comment by all interested parties. Other carriers urge limiting the proposal to arrangements that affect a limited amount of inbound and outbound traffic on the route (Ameritech, Level Three), or by creating a presumption that a carrier with 25 percent market share has market power (TRA). Each of these more restrictive approaches to lifting the ISP is unnecessary and would substantially delay or negate the pro-competitive benefits of lifting the ISP.

### 1. The Commission should not adopt AT&T's proposal to require the Commission to find affirmatively that a foreign carrier lacks market power in a foreign country as a prerequisite for lifting the ISP.

No carrier argues that whipsawing remains a serious threat where the foreign carrier lacks market power. However, some carriers seek to limit the Commission's proposal through back door approaches that focus on the question of whether the foreign carrier lacks market power in the foreign market. For instance, AT&T argues that the Commission must decide whether a foreign carrier lacks market power in any given country on a public record after all interested parties have had an opportunity to comment. [1]

A pre-approval process to determine whether the foreign carrier has market power in the foreign market is unnecessary, would create an undue administrative burden for both the Commission and U.S. carriers seeking to enter into new arrangements with foreign carriers and would delay significantly the process of moving away from an ISP model in situations where such a model inhibits competition. It would both delay the benefits stemming from the new agreements as well as inhibit the development of emerging U.S. and foreign carriers and the additional competition they bring to the market. Such delays and anticompetitive effects are unnecessary, given the undeniable fact that in the vast majority of foreign markets today the question of whether a carrier has market power is readily apparent.[2] Further, in those rare cases where a legitimate question arises on this score, the Commission, on its own or at the request of an interested party, could require the U.S. carrier to furnish additional information regarding the arrangement, perhaps on a confidential basis, to determine whether the foreign carrier has market

[1] AT&T Comments at 5.

[2] *Notice* at ¶11.

power.

### 2. The Commission should not restrict the scope of its proposal to arrangements that affect a limited amount of traffic or by presuming that foreign carriers with less than 50 percent market share have market power.

Likewise, the Commission should not restrict the scope of its proposal to lift the ISP to arrangements that affect a limited amount of traffic[3] or by presuming that foreign carriers with less than 50 percent market share in the foreign market possess market power.[4] Each of these proposals fails to give adequate consideration to the anticompetitive effects of the ISP in markets where competition is developing and the fact that, so long as the foreign carrier lacks market power, it will rarely have the ability to whipsaw U.S. carriers because of the availability of alternative means for terminating traffic in the foreign country.

## B. THE COMMISSION SHOULD ADOPT ITS PROPOSAL TO LIFT THE ISP FOR ARRANGEMENTS IN WTO MEMBER COUNTRIES TO WHICH THE COMMISSION AUTHORIZES ISR.

The majority of commenters, including SBC, GTE, BT, RSL Com, NTTA, Qwest, CompTel, Cable & Wireless, Telia NA, Telegroup, Deutsche Telekom, BellSouth, Bell Atlantic and TISA, support the Commission's proposal to eliminate the ISP for arrangements with foreign carriers in WTO member countries where it has authorized ISR. Although several parties urge

[3] Ameritech urges the Commission to lift the ISP only for (1) settlement agreements that affect less than 25 percent of the traffic on a particular route and which are between U.S. carriers and foreign carriers from WTO member countries that permit multiple operator entry to the market; (2) or for routes where transparent, nondiscriminatory, cost-based international termination charges are available on both ends of the route. Ameritech Comments at 4. Level 3 urges retaining the ISP for all arrangements affecting 10 percent or more of the inbound or outbound traffic on a route. Level 3 Comments at 3.

[4] The TRA argues that, because eliminating the filing requirements deprives the Commission of a realistic opportunity to assess the foreign carrier's market power, the Commission should adopt the presumption that a foreign carrier with 25 percent or more market share possess market power. TRA Comments at 4.

the Commission to lift the ISP more broadly than it proposes,[5] the two international carriers with the largest market shares, AT&T and MCI, each of which has a vested interest in slowing the development of competition in the international telecommunications services market, oppose the Commission's proposal and offer counter-proposals of their own.

AT&T argues that the Commission should lift the ISP only on routes (1) where the foreign dominant carrier's settlement rates are at "best practice" levels or (2) where "viable ISR opportunities" exist in the foreign country.[6] MCI urges the Commission to lift the ISP for arrangements between U.S. carriers and foreign carriers with market power only on WTO member country routes in which (1) at least 50 percent of the traffic on the route is settled within two cents of the best practice rates; or (2) the foreign market affords U.S. carriers equivalent ISR opportunities.[7] However, neither "best practices rates" nor "equivalency" tests provide as appropriate a standard for lifting the ISP on a route-specific basis as does the standard which the Commission proposes.

### 1. The Commission should not adopt GTE and NTTA's proposal to lift the ISP on all routes involving WTO member countries.

GTE and NTTA support lifting the ISP on all routes involving WTO member countries, on the theory that keeping restrictions in place creates the perception that the Commission cannot fully rely on the WTO agreement, which in turn may undermine the confidence of other parties

[5] Telia NA urges the Commission to lift the ISP altogether. GTE, NTTA, and others urge the Commission to eliminate the ISP on all routes involving WTO Member countries, regardless of whether ISR is authorized in the foreign country and regardless of whether the foreign carrier possesses market power.

[6] AT&T Comments at 6-15.

[7] MCI Comments at 6.

in that agreement.[8] NTTA proposes, in the alternative, that the Commission eventually eliminate the ISP in all WTO member countries.[9]

SBC does not support lifting the ISP on all routes involving WTO member countries. Foreign carriers possessing market power retain some ability to whipsaw U.S. carriers even in WTO Member countries. So long as settlement rates in the foreign country are at or below benchmark rates, any harm to the public interest that whipsawing might cause would be limited. However, without a requirement that settlement rates are at reasonable levels (i.e., benchmark levels), there remains a significant potential for harm to the public interest resulting from foreign carriers whipsawing U.S. carriers, even in WTO Member countries. Thus, so long as settlement rates in the foreign carrier's market are above benchmark rates, the potential harm to U.S. interests whipsawing causes may outweigh the pro-competitive benefits of lifting the ISP.

SBC supports NTTA's alternative proposal that the Commission should establish the elimination of the ISP in all WTO member countries as a goal toward which the Commission should proceed in due course. Likewise, in line with a similar CompTel proposal,[10] SBC proposes that, 12 months from its entry of an order, the Commission should initiate a study to determine whether it should lift the ISP as to all arrangements involving traffic originating or terminating in WTO Member countries.

[8] GTE Comments at 13; NTTA Comments at 3.

[9] NTTA Comments at 5.

[10] CompTel Comments at 7.

### 2. The Commission should reject alternative proposals based on a requirement that settlements meet "best practice" rates.

Alternative proposals based on a requirement that settlement rates meet so-called "best practice" rates, instead of benchmark rates, are inferior to the Commission's proposal.

In its Benchmarks Order,[11] the Commission established "benchmarks" to govern the international settlement rates that U.S. carriers may pay foreign carriers to terminate international traffic originating in the United States. The Commission explained that its establishment of benchmark rates was an integral part of its plan to restructure the economics of the U.S. international market to promote "low cost, technologically innovative interconnectivity" globally.[12] As a predicate to establishing benchmark rates, the Commission conducted an investigation, which included an evaluation of foreign carriers' publicly available tariff rates and information published by the ITU, an assessment of each country's level of economic development, and a detailed analysis of why the benchmark rates represent presumptively just and reasonable rates.[13] The Commission concluded that settlement rates that were at or below benchmarks were "reasonable" and that its Benchmarks Order would "substantially reduce the excess in current settlement rates in a manner that treats foreign carriers fairly."[14] Under these circumstances, for the Commission to tie the lifting of the ISP on

[11] *International Settlement Rates,* IB Docket 96-261, Report and Order, 12 FCC Rcd 19806 at ¶ 244 (1997) "*Benchmarks Order*"), *recon. pending, appeal filed, Cable & Wireless et al. v. FCC,* No. 97-1612 (D.C. Cir. filed Sept. 26, 1997).

[12] *Id.* at ¶ 1.

[13] *Id.* at ¶¶ 19, 26.

[14] *Id.* at ¶¶ 20, 26.

a route-specific basis to the question of whether settlement rates meet benchmark requirements is reasonable and consistent with the Commission's prior findings.

The so-called "best-practices" rate, on the other hand, is not the product of any kind of a similar determination, but represents the lowest settlement rate at any given point in time, without regard to whether that rate is reasonable or appropriate in a particular country and without regard to the foreign country's level of economic development. There is no basis for requiring "best practices" rates as a prerequisite for lifting the ISP on a route-specific basis.

The incumbent IXCs' argument in favor of requiring "best practices" is that, even in markets where settlement rates are at benchmark levels, a foreign carrier possessing market power would still have the power to whipsaw U.S. carriers to prevent reductions in settlement rates below benchmarks.[15] The argument ignores the extent to which new competition and alternative mechanisms for terminating international traffic that will develop as a result of lifting the ISP, will be the most effective way to bring additional downward pressures on prices. In the interim, any harm to the public interest remains limited so long as settlement rates remain at or below benchmark levels. On balance, the pro-competitive benefits of lifting the ISP on routes where the Commission has authorized U.S. carriers to provide ISR would significantly outweigh the hypothetical, transitory, and, at most, limited harm potentially associated with lifting the ISP on such routes.

### 3. The Commission should reject alternative proposals requiring the foreign market to meet some variation of the "equivalency" test.

Both MCI's proposed "equivalency" requirement and AT&T's proposed requirement that "viable ISR opportunities" exist in the foreign country (which, practically speaking, amounts to

[15] AT&T Comments at 9.

an "equivalency" test), would unnecessarily impose an unacceptable administrative burden on both the Commission and competitors seeking entry into foreign markets. Indeed, the prospect of delay and the uncertainty associated with the outcome of an "equivalency" proceeding would, in many instances, deter competitive entry. In WTO countries where 50 percent of traffic is settled at benchmark rates, the limited potential for harm caused by lifting the ISP does not warrant such an anticompetitive result.

To justify such a result, AT&T paints a bleak picture of competitive market conditions in WTO Member countries. AT&T focuses on the fact that, of the more than 130 WTO member countries, only 28 committed to competition on January 1, 1998.[16] What AT&T ignores, however, is that those countries which made market opening commitments under the WTO Agreement represent 97% of the total basic telecommunication service revenues for WTO member countries.[17] Further, even countries not making market opening commitments are subject to the GATS principles of Most Favored Nation treatment and its requirement of reasonable, objective and impartial regulation.[18] AT&T also fails to acknowledge the extent to which arrangements that permit arbitrage of the settlements process, or which bypass that process altogether, are rapidly becoming the dominant means of carrying international traffic. As GTE correctly states, the volumes of bypass in arbitrage traffic are growing rapidly, perhaps amounting to more than 50 percent of all international phone traffic.[19]

[16] *Id.* at 6, n. 7

[17] *Rules and Policies on Foreign Participation in the U.S. Telecommunications Market*, IB Docket No. 97-142, FCC 97-195, Order and Notice of Proposed Rule Making, ("*Foreign Participation Order*") (*rel.* June 4, 1997) at ¶ 35.

[18] *Id.* at ¶ 36; *see also* GTE Comments at 8.

[19] GTE Comments at 2-3, *citing Communications Week International* No. 187 p. 4 (June 30, 1997). GTE's

SBC supports the Commission's proposal to lift the ISP for arrangements in WTO member countries on routes where the Commission has authorized ISR. Alternatively, however, to encourage foreign countries to permit the termination of ISR traffic within their borders, SBC supports one additional requirement: that the laws of the foreign country permit U.S. carriers to provide service via ISR. Under this alternative proposal, no proceeding need be instituted to determine the "equivalency" or "viability" of ISR opportunities in the foreign country; carriers need not look beyond whether "the foreign market permits U.S. carriers to provide service via ISR."[20]

## III. THE FLEXIBILITY POLICY

### A. THE FCC SHOULD ELIMINATE THE AFFILIATE FLEXIBILITY SAFEGUARD WHERE THE AFFILIATE LACKS MARKET POWER.

The Commission should eliminate the flexibility safeguard applicable to affiliated carriers and non-equity joint-venture partners where the affiliated carrier or joint-venture partner lacks market power in the foreign market. All parties commenting on the issue, including Cable and Wireless, Telia NA, TRA, AT&T, PrimeTECH, Bell South, and Bell Atlantic, agreed that there was no need for the safeguard where the affiliated carrier or joint venture partner lacks market power.

## IV. COMPETITIVE SAFEGUARDS

### A. WHERE THE ISP NO LONGER APPLIES, THE COMMISSION SHOULD LIMIT THE NO SPECIAL CONCESSIONS RULE.

The majority of commenters agree that, as to arrangements to which the ISP does not

Comments contain detailed evidence of the extent to which alternative mechanisms for terminating international traffic have marginalized the international settlements system.

[20] *Notice* at ¶ 29.

apply, the Commission should make clear that the No Special Concessions rule does not apply to the terms and conditions under which traffic is settled (including allocation of return traffic), but that, otherwise, the Commission should retain the No Special Concessions rule. In its initial comments, SBC agreed that the No Special Concessions rule should not apply to the terms and conditions under which traffic is settled. Additionally, SBC expressed its concern that, like the ISP, the No Special Concession rule tends to inhibit competition in markets where competition is developing and urged the Commission to limit the scope of the No Special Concessions rule.

In circumstances where the No Special Concessions rule continues to apply, it should be limited to exclusive arrangements affecting facilities, services or functions in the particular markets in which the foreign carrier actually has market power. Even if there are legitimate concerns that a foreign carrier may act anticompetitively as to those segments of the market over which it has market power, the same concerns do not exist as to markets over which the foreign carrier does not have market power. For instance, a foreign carrier with market power in the foreign local access market but not in the intercity or international transport markets may act anticompetitively only as to the local access market, not as to the intercity or international transport markets. SBC's proposed rule addresses the concerns of commenters who support retaining the No Special Concessions rule, while giving U.S. carriers greater negotiating freedom where the ISP no longer applies.

### B. THE COMMISSION SHOULD PERMIT ALL CARRIERS TO NEGOTIATE ARRANGEMENTS TO ACCEPT "GROOMED" TRAFFIC.

MCI urges the Commission to prohibit ILECs from entering into "grooming" arrangements with foreign carriers possessing market power.[21] AT&T urges the Commission to prohibit BOCs from entering into grooming arrangements with foreign carriers, regardless of whether the ISP applies and regardless of whether the foreign carrier has market power.[22] SBC strongly disagrees with both MCI and AT&T and urges the Commission to permit grooming arrangements as to all arrangements not subject to the ISP.[23] To support its position, SBC submits the Declaration of Dr. Jerry A. Hausman, attached.

#### 1. Prohibiting ILEC or BOC "grooming" arrangements is economically inefficient and places ILECs and BOCs at a competitive disadvantage.

Grooming represents but one example of the type of innovative and efficient arrangements that will characterize the international services market in a non-ISP world. The Commission's proposals to lift the ISP for foreign carriers without market power and on liberalized routes are based on its recognition that in these situations market forces and aggressive commercial negotiations among carriers better serve U.S. interests, and will ultimately result in lower rates for U.S. international services, than the outmoded ISP. Without an ISP, there is no legitimate rationale for maintaining a restriction on grooming arrangements – indeed, lifting the ISP makes grooming restrictions instantly anomalous. U.S. carriers will be free to negotiate different prices for exchanging traffic with foreign carriers based on any number of factors (e.g., volume of traffic, the types and ownership of the facilities used, the willingness to enter into long-term commitments, time-of-day of the traffic, geographic location, etc.). The

[21] MCI Comments at 10-11.

[22] AT&T Comments at 33-34.

[23] SBC confines its arguments in favor of grooming arrangements to situations in which the ISP does not apply, either because the ISP has been lifted as a result of policies adopted in this proceeding or because traffic is being terminated under a currently authorized non-ISP arrangement, such as ISR. Nevertheless, there are many instances in which grooming would be appropriate even in an ISP environment.

terms and availability of grooming arrangements (the U.S. carrier's geographic allocation of traffic) will be one such factor, as U.S. carriers with lower costs for terminating certain types of traffic compete for that traffic by basing their prices more closely on their costs.

For such non-settled traffic there is no basis for the claims of AT&T and its expert Dr. Lehr that grooming will result in higher costs for other carriers because they will be "forced to accept a mix of traffic with higher termination costs."[24] Without the ISP, no carrier has a regulatory right to insist on receiving, or is forced to accept, any particular amount or type of U.S.-bound traffic. If an IXC is of the view that its costs of terminating certain traffic exceed the compensation the foreign carrier is offering for that service, it can decline to carry the traffic unless the payments are increased. What AT&T/Lehr are really complaining about is that without the ISP, new competing international carriers like BOC LD Affiliates will compete for terminating traffic by offering lower prices, especially for lower cost traffic. This is how a competitive market works. It is only in the unique "through-the-looking-glass" ISP world, AT&T's preferred operating environment, that competing for traffic by offering prices based on costs could be deemed anticompetitive and worthy of regulatory prohibition.

Thus, as MCI concedes, grooming arrangements allow U.S. carriers to terminate international traffic where their costs of doing so are lowest. For example, carriers with national presences may agree to terminate East coast traffic at East coast facilities, and West coast traffic at West coast facilities, where the costs of handling the traffic and transporting it to its ultimate destination is the least expensive. MCI admits that "[t]his type of grooming arrangement will

[24] Lehr Declaration at 10.

lower the U.S. carrier's costs," providing "an increase in efficiency, with no offsetting losses."[25] Likewise, IXCs with regional networks have an incentive to negotiate arrangements for terminating traffic where they have their own facilities. Moreover, all carriers have incentives to terminate traffic in regions where access charges are relatively low.

Accordingly, ILECs and BOCs need the freedom to enter into grooming arrangements for no reason other than to meet competition. Anti-grooming rules applicable solely to BOCs or ILECs place SBC at a competitive disadvantage vis-a-vis competitors not shackled with such restrictions, making it unnecessarily difficult for SBC to negotiate successfully non-ISP arrangements to terminate foreign traffic.

By way of analogy, consider the practice of geography-based pricing which, in today's ISR market, is even more prevalent than grooming. U.S. carriers enter into agreements to terminate ISR traffic under price terms that may vary by State, by LATA, or even by the U.S. exchange number in which the international call is terminated. With geography-based pricing, U.S. carriers are able to negotiate rates for terminating traffic at low-cost locations that are lower than a U.S. carrier would be able to negotiate basing its rate on a single, averaged rate. Just as prohibiting this kind of arrangement would place the BOCs at a competitive disadvantage vis-a-vis carriers not so restricted, prohibiting BOCs from entering into agreements to accept groomed traffic would require BOCs—and no other carrier—to perpetuate productive inefficiencies in its arrangements for accepting inbound traffic.

[25] *See also* Hausman Declaration at ¶¶ 6,7, 11-13.

### 2. MCI and AT&T's arguments that permitting BOCs to accept groomed traffic would permit BOCs to engage in anticompetitive conduct ignores the facts, the law, the economic realities, and prior Commission findings.

The principal argument of MCI and AT&T is that, because the Commission has set BOC access charges above the BOCs' incremental cost of providing access, a BOC incurs a lower cost of access for calls terminating in its region than do other U.S. carriers. Thus, the argument goes, a BOC's long distance affiliate can offer foreign carriers a lower inbound rate than other carriers, engaging in "grooming . . .to take advantage of above-cost access charges imposed imposed on competitors."[26] This argument is unsound, for the following reasons.

First, MCI and AT&T offer nothing other than speculation to support their argument that BOC long distance affiliates would set their rates for terminating international traffic based on the BOC's incremental costs of providing access, rather than the price the long distance affiliate pays the BOC for access. The reality is that, as a matter of both statute and FCC regulation, the BOC long distance affiliate must pay the same access charges as other IXCs.[27] The FCC has further held that failure of a BOC interLATA affiliate to charge rates that exceed its own incremental costs of providing service would violate sections 201 and 202 of the Communications Act, as well as federal (and possibly state) antitrust law.[28] Because the long distance affiliate's prices to foreign carriers for terminating their in-bound U.S. traffic in the

[26] Letter from Kenneth A. Schagrin, MCI Communications Corporation, to Magalie Roman Salas, Federal Communications Commission, IB Docket No. 97-142 (July 20, 1998), cited in MCI Comments at 10.

[27] 47 U.S.C. § 272(e)(3); *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended*, CC Docket No. 96-149, First Report and Order and Further Notice of Proposed Rulemaking, 11 FCC Rcd 21905 (1996) ("*Non-Accounting Safeguards Order*") at ¶ 256.

[28] *Non-Accounting Safeguards Order* at ¶ 258; *Regulatory Treatment of LEC Provision of Interexchange Services*, 12 FCC Rcd 15756, 15,837-39 (1997) ("*LEC Regulatory Treatment Order*") at ¶ 128.

BOCs' regions must be set high enough to recover all incremental costs, including all access charges paid by, or imputed to, the long distance affiliate, there is no basis for the AT&T/MCI complaint about the BOCs' enjoying an "artificial" or "unfair" cost advantage.

Second, the AT&T and MCI arguments are virtually identical to the "price squeeze" arguments these carriers have raised in other proceedings to try to convince the Commission to impose onerous restrictions on the BOCs' domestic long distance operations. As they do here, the IXCs argued in these other proceedings that because access is priced above "economic cost," BOCs have an inherent cost advantage over IXCs that they can exploit anticompetitively in providing long distance service. The Commission has rejected these arguments consistently. LEC Regulatory Treatment Order at ¶¶ 125-30 (rejecting dominant carrier classification for BOC long distance affiliates based on asserted access charge advantage); Non-Accounting Safeguards Order at ¶ 258 (rejecting MCI argument that the Commission should regulate BOC long distance affiliates' prices or profits because access charges are above cost). Further, because the Commission has held that "no practical distinctions exist between a BOC's ability and incentive to use its market power in the provision of local exchange and access services to disadvantage unaffiliated domestic interexchange competitors as opposed to international service competitors," there is no reason for a different conclusion in the current context. LEC Regulatory Treatment Order at ¶ 138.[29]

[29] The Commission has even dealt with an AT&T argument that BOCs could engage in a domestic form of grooming by marketing "their out-of-region interexchange services to customers who routinely terminate in the BOCs' . . . in-region local exchange and exchange access area." *LEC Regulatory Treatment Order* at ¶ 210 n.603. While acknowledging this possibility, the Commission concluded that it called for no special regulatory treatment of the BOCs' out-of-region long distance services or any limitations on their ability to compete aggressively for traffic terminating in their regions. Rather, the Commission concluded that price caps regulation of access charges and the imputation of such charges to BOC long distance affiliates were more than sufficient to protect against any potential anticompetitive impacts. *Id.* at ¶¶ 210-13. It declined even to impose separate affiliate requirements on BOCs for their out-of-region long distance operations despite arguments that these and other restrictions were necessary in

Third, MCI and AT&T's arguments are founded on the assumption that access charges the Commission sets are too high. But, the implicit subsidies imbedded in access charges are unsustainable in a competitive market and, as a matter of law, sound regulatory policy, and competitive equity, they must be removed and replaced with explicit support mechanisms. The Commission has started, but not yet completed, this process. Contrary to the IXC's arguments, the requirement that BOCs continue to fund universal service by pricing access above cost is a major disadvantage in a competitive market. It makes some of the BOCs' most lucrative customers, such as businesses with large volumes of access traffic, vulnerable to being picked off by competitors that do not have to inflate their prices with government-mandated subsidies. For example, MCI/WorldCom's new On-Net Service targets major business customers by providing end-to-end service at lower prices based, in part, on bypassing LEC access charges.[30] SBC recognizes that this is how the competitive market is increasingly going to operate. It would be truly ironic, however, as well as anticompetitive, inefficient, and inequitable, if the subsidy-laden access charges that are the source of competitive disadvantage for BOCs in attempting to retain their most profitable customers became the basis for imposing anticompetitive restrictions on their long distance affiliates.

Fourth, replying to Dr. Lehr, Professor Hausman demonstrates that it would be economically irrational for BOCs to use their incremental margin for access charges to cross-subsidize their long distance affiliate. As Professor Hausman explains, such a strategy is economically rational only if the BOC could drive AT&T and other IXCs out of business, which

light of the BOCs' alleged access charge advantage for terminating traffic in-region.

[30] See "New MCI WorldCom Unveils Flat-Rate Bundled Service for Businesses," Communications Daily, September 29, 1998, 4-5.

would not be possible because of the large IXCs' current market share, the large sunk costs of the IXC networks (which make the cost of exit high) and the significant margin of price over incremental costs for both domestic long distance and international toll.[31] The strategy Dr. Lehr attributes to the BOCs is, therefore, economically irrational because it would cause BOCs to lose money, without hope of gaining an offsetting advantage.

Fifth, the IXCs have a counterbalancing advantage to the BOCs in the current market. While BOCs have local access facilities, the IXCs have international transport and intercity facilities which again are priced above marginal (incremental) costs because of the fixed costs of their networks. To terminate international calls, each group must purchase services or lease facilities from the other.[32] It would be disingenuous to hobble the new entrants in the international services market based on characteristics of the local exchange market, given that the incumbents, including AT&T with its 65% market share, have natural advantages based on their ownership of a national (and international) network.

Finally, AT&T argues that permitting BOCs to accept groomed in-bound international traffic would allow them to "raise their rivals' costs." As Professor Hausman explains,[33] this argument is faulty. It is true that allowing carriers to compete for terminating U.S. in-bound traffic will tend to lower prices for that service compared to the situation under the ISP. The same is also true of virtually all non-ISP arrangements, including ISR and providing service on a "whole circuit" basis. The fact that, under any of these scenarios, incumbent U.S. carriers will

[31] Hausman Declaration at ¶¶ 25, 26.

[32] *Id.* at ¶22.

[33] *Id.* at ¶¶ 30-33.

no longer automatically receive U.S.-bound traffic based on a regulatory allocation formula (i.e., proportionate return) is not properly characterized as "raising rivals' costs" in any economically meaningful sense. Rather, all these non-ISP arrangements cause prices to comport more closely with costs, which increases efficiency and is a principal goal of competition. In short, for those situations in which the Commission decides it does not want U.S. carriers to compete for terminating traffic, it should keep the ISP in place. However, once it decides to lift the ISP on a given route or for a given set of foreign carriers, there is no reason to single out grooming by ILEC or BOC long distance affiliates for any special restrictions, and certainly no reason to do so based on spurious claims that, by allowing new entrants to compete for U.S. in-bound traffic, such arrangements raise the costs of the incumbent oligopolists.

## V. CONCLUSION

Once again, SBC applauds the deregulatory approach to the international settlements process contained in the Commission's Notice and urges the Commission to promulgate rules that:

1. lift the ISP and related filing requirements for arrangements with foreign carriers lacking market power in WTO Member countries;

2. lift the ISP and related filing requirements even if the foreign correspondent possesses market power, provided the arrangement involves a WTO Member country where the Commission authorizes ISR and, if the Commission finds the further requirement necessary, the laws of the foreign country permit U.S. carriers to provide service via ISR;

3. lift the No Special Concessions rule in all circumstances in which the ISP no longer applies, or, at the very least, limit the No Special Concessions rule to arrangements affecting

facilities, services, or functions in the particular markets in which the foreign carrier possesses market power;

4. eliminate the flexibility safeguard presently applicable to arrangements involving, foreign affiliates or non-equity joint ventures that lack market power;

5. permit all parties to negotiate arrangements to accept groomed traffic where the ISP does not apply.

Respectfully submitted,

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October 16, 1998

## CERTIFICATE OF SERVICE

I, Steven D. Strickland, hereby certify that a copy of the foregoing "Reply Comments of SBC Communications Inc." in CC Docket No. 90-337 was served this 16th day of October 1998 on the parties on the attached sheet:

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October 16, 1998

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Declaration of Prof. Jerry A. Hausman

1. I am MacDonald Professor of Economics at the Massachusetts Institute of Technology in Cambridge, Massachusetts, 02139.

2. I received an A.B. degree from Brown University and a B.Phil. and D. Phil. (Ph.D.) in Economics from Oxford University where I was a Marshall Scholar. My academic and research specialties are econometrics, the use of statistical models and techniques on economic data, and microeconomics, the study of consumer behavior and the behavior of firms. I teach a course in "Competition in Telecommunications" to graduate students in economics and business at MIT each year. Competition in long distance is one of the primary topics covered in the course. I was a member of the editorial board of the Rand (formerly the Bell) Journal of Economics for the past 13 years. The Rand Journal is the leading economics journal of applied microeconomics and regulation. In December 1985, I received the John Bates Clark Award of the American Economic Association for the most "significant contributions to economics" by an economist under forty years of age. I have received numerous other academic and economic society awards.

3. I have done significant amounts of research in the telecommunications industry. My first experience in this area was in 1969 when I studied the Alaskan telephone system for the Army Corps of Engineers. Since that time, I have studied the demand for local measured service, the demand for intrastate toll service, consumer demands for new types

of telecommunications technologies, marginal costs of local service, costs and benefits of different types of local services, including the effect of higher access fees on consumer welfare, demand and prices in the cellular telephone industry, and consumer demands for new types of pricing options for long distance service. I have also studied the effect of new entry on competition in paging markets, telecommunications equipment markets, and interexchange markets and have published a number of papers in academic journals and books about telecommunications. I have also edited two books on telecommunications, Future Competition in Telecommunications (Harvard Business School Press, 1989) and Globalization, Technology and Competition in Telecommunications (Harvard Business School Press, 1993). My two most recent published academic research papers on telecommunications are: "Valuation and the Effect of Regulation on New Services in Telecommunications," Brookings Papers on Economic Activity: Microeconomics, 1997 and "Taxation By Telecommunications Regulation," Tax Policy and the Economy, 1998. In both of these papers I estimate the effect of FCC policies on economic efficiency and consumer welfare.

4. I have previously provided affidavits to the FCC on competition among long distance providers. I submitted an affidavit to the FCC in November 1993 regarding competition for Basket 1 services in the long distance industry as part of the AT&T dominance proceeding. I also submitted affidavits in 1994 and 1995 on competition among long distance providers to the Department of Justice (DOJ) regarding the waiver request of the Bell Operating Companies (BOCs) to provide cellular long distance and to provide landline long distance service. I have submitted affidavits in the FCC Dominance

Proceeding regarding BOC entry into interLATA service in 1996 and with respect to BellSouth's 271 filings in South Carolina, Louisiana, and Georgia in 1997 and 1998.

5. In this declaration, I am addressing grooming in situations to which the International Settlements Policy (ISP) does not apply to the traffic in question. In such a "non-ISP world," U.S. and foreign carriers negotiate commercial, market-driven arrangements to exchange traffic absent the restrictions of the ISP, such as uniformity and equal division of accounting rates and proportionate return of U.S.-bound traffic. Indeed, in a non-ISP arrangement, there are not "settlement payments" in the regulatory sense of the term, but simply contractual payments between carriers to provide each other with services necessary to originate, transport, and terminate international calls.

I. Summary and Conclusions

6. Grooming of international long distance calls will lead to cost savings. Decreases in costs lead to increases in productive economic efficiency. Productive economic efficiency is perhaps the most important goal of economic policy since it implies that economic resources are not wasted. The Commission should carefully consider any policy, such as a prohibition on grooming, which causes a decrease in productive efficiency.

7. Economic analysis demonstrates that decreases in costs will be passed on, at least in part, to consumers. When costs decrease for a firm, it is in the firm's profit-making best interest to pass along part of the cost savings in terms of lower prices

because reduced price leads to more demand and higher revenue. In the current situation where the price elasticity for international calls is recognized to be quite high, the amount of cost savings pass-through in terms of lower prices is likely to exceed the actual amount of cost savings. Thus, a prohibition on grooming by the Commission will lead to significantly higher prices for consumers.

8. Dr. William Lehr, who submitted an affidavit on behalf of AT&T, fails to recognize the gains in economic efficiency and the resulting lower prices for consumers. Instead he ascribes economically irrational economic incentives to the ILECs in claiming they will "cross-subsidize" their international toll services. Dr. Lehr is incorrect for two further reasons. First, the BOC affiliate that will sell international toll service will be a separate subsidiary that will not be price regulated and will pay the same access rates as other IXCs. Second, long distance access prices are regulated by price caps so that no cost shifting can occur.

9. Likewise, Dr. Lehr's "raising rivals costs" argument is incorrect. He wants the Commission to forbid an ILEC from competing for international traffic by offering lower prices to consumers. The result of Dr. Lehr's proposal would be a continued oligopoly situation where AT&T, MCI Worldcom, and Sprint have approximately 97% of international toll traffic according to the latest FCC data. The outcome favored by Dr. Lehr will favor AT&T, which has 65% of international toll traffic, but it will harm consumers because of higher prices.

10. Grooming will lead to lower prices for U.S. consumers, not merely to benefits to foreign carriers and foreign consumers. This benefit to U.S. consumers will occur both in the situations where the BOCs' Long Distance affiliates provide international long distance service and where they are not yet permitted to do so. U.S. consumers will benefit either if competition occurs at the foreign end or whether a monopoly carrier exists. However, greater benefits to U.S. consumers will occur when the BOCs' Long Distance affiliates are permitted to provide service and competition occurs at the foreign end.

## II. Cost Savings and Economic Efficiency

11. Grooming leads to a cost savings for terminating traffic because it permits carriers to terminate traffic where they can do so most efficiently. For instance, a foreign carrier would separate its terminating U.S. traffic according to the geographic destination and hand off its West Coast terminating traffic to one carrier in California and its East Coast terminating traffic to another carrier in New York. Similarly, U.S. carriers seek to terminate traffic where they can do so most efficiently because of the existence of integrated local facilities, the fact that access charges vary by location, and other cost-saving factors. By reducing "cross hauling", i.e. the use of inefficient network routing, and the number of companies that need to switch the data on their networks, cost savings result. The result is a gain in economic efficiency. [1]

[1] MCI recognizes the efficiency gains from grooming of international traffic in its Ex Parte presentation of June 25, 1998.

12. Productive economic efficiency is perhaps the most important goal of economic policy because it implies that economic resources are not wasted. If cost savings exist which are not utilized due to a regulatory ruling, it means that the economy could produce more output if the regulatory rule were eliminated. The Nobel-prize winning economist Paul Samuelson states in his classic textbook:

> "Efficiency is a central (perhaps the central) concern in economics. Efficiency means there is no waste....Productive efficiency occurs when society cannot increase the output of one good without cutting back on another. An efficient economy is on its production-possibility frontier."[2]

Because a prohibition on grooming prohibits a cost saving practice and decreases economic efficiency, the Commission should carefully consider any policy, such as a prohibition on grooming that causes a decrease in productive efficiency. Only extremely strong countervailing reasons should ever be permitted to cause the Commission to adopt regulation that decreases productive economic efficiency.

13. Regulatory rules often lead to difference in prices between a competitive outcome and a regulated outcome. For example, the universal service fund leads to these types of price differences, i.e., some services being priced above cost in order to subsidize other services being priced below cost. The Commission has decided that it is in the public interest to have a universal service fund. However, these price distortions, or lack of allocative economic efficiency, are typically much less harmful to the economy

than the absence of productive economic efficiency. Indeed, economists refer to the absence of productive economic efficiency as a "first order" economic welfare loss, while price distortions create a "second order" economic welfare loss.[3] Thus, while the absence of productive economic efficiency means that regulation is leading to wasted resource in the economy, price distortion caused by regulation does not typically create wasted resources. Under a mixed regulated/competitive framework, competitors of the regulated company often try to create productive economic inefficiencies because the regulated company will have higher costs and will not be able to compete as well.[4]

## III. Cost Savings Lead to Lower Prices to Consumers

14. Cost savings, at least in part, are passed on to consumers in terms of lower prices. To begin with the extreme case of a monopolist, price will decrease when marginal cost decreases. Claims that a monopolist will "pocket the cost savings" and not pass them on to consumers are incorrect. The incorrect claim, which is often made, is that only competition forces a firm to pass along cost savings. However, profit maximization by the firm causes it to pass along at least some of the cost savings in terms of a lower price. Competition causes even more of the cost savings to be passed on to consumers.[5] For example, the minimum cost savings passed on by a monopolist is ½ of

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[2] P.A. Samuelson and W.D. Nordhaus, Economics, 12th ed. McGraw-Hill, 1985, pp. 28-29.

[3] By first and second order welfare losses I mean the corresponding term in a Taylor's expansion around a Pareto efficient point. The allocative efficiency loss from regulation arises because the regulated price exceeds the competitive price and leads to a "deadweight loss". For a further discussion of deadweight loss and its measurement see e.g. A. Auerbach, , "The Theory of Excess Burden and Optimal Taxation", in A. Auerbach and M. Feldstein, Handbook of Public Economics, Amsterdam, 1985 and J. Hausman, "Exact Consumer's Surplus and Deadweight Loss", American Economic Review, 71, 1981.

[4] This outcome is recommended by MCI, see Ex Parte comments, ibid. and by AT&T, "Comments of AT&T Corp. September 16, 1998, pp. 33-35.

[5] See J. Hausman and G. Leonard, "Efficiencies from the Consumer Viewpoint", forthcoming in George Mason Law Review, 1999.

cost savings while under competition the minimum amount of cost savings passed on in lower prices will be 2/3.

15. Profit maximizing behavior causes some of the cost savings to be passed along because a monopolist sets its price so that marginal revenue equals marginal cost. If the monopolist lowers its price (by a small amount), three effects occur. First, the monopolist achieves lower revenue on its sales; next it sells more because of the lower price; and lastly its total costs increase because of the extra production.[6] At the profit maximizing point, the net effect of these three terms is zero—they cancel each other out.[7] However, if the last term, which is the cost of the extra production, becomes smaller due to efficiencies, the net effect is positive because the added revenue from the price decrease exceeds the added production cost.[8] Thus, the monopolist can increase its profits by reducing its price, to cause marginal revenue and marginal cost to be equal once again.

16. Competition causes even more of the cost savings to be passed on to consumers because when one firm lowers its price, other competing firms will be forced to lower their prices, or they will lose a significant amount of their customers. Thus, the effect of a Commission rule that prohibits cost savings caused by grooming could well lead to significantly higher price for consumers.

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[6] A price increase can be analyzed in a similar way where the signs of each term are changed.

[7] A small price increase leads to the same result—the three terms cancel each other out.

17. The minimum amount of cost savings that a monopolist will pass on to consumers in terms of lower prices is ½ of cost savings, given reasonable assumptions about the shape (local convexity) of the demand curve while under competition the minimum amount is 2/3 of cost savings.[9] With imperfect competition (price above marginal cost) which will exist with toll service because of the significant fixed costs of the networks, the 2/3 amount will provide the least amount of cost savings passed on, but the expected amount to be passed on will be even larger.

18. Given the knowledge about demand functions for international toll service, I expect more than 100% of the cost savings would be passed on to consumers by ILECs if they are permitted to groom their traffic. Two reasons exist for this expectation. First, the price elasticity for international calls is high (in magnitude) compared to other telecommunications service elasticities. The empirical findings are that it significantly exceeds the domestic toll call elasticities.[10] Second, estimated elasticities for both international and domestic interLATA toll calls have been relatively stable despite significant price decreases of the order of 50% or more, which implies that the demand curves have a functional form with approximately constant elasticity. The conclusion is that these two economic factors will cause a profit maximizing firm to pass on more than 100% of the cost savings.

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[8] This result requires that the price elasticity exceeds 1.0 (in magnitude) which it always does because of profit maximization. See e.g. D.W. Carlton and J.M. Perloff, Modern Industrial Organization, Scott, Foresman, 1990, p. 103.
[9] See J. Hausman and G. Leonard, op. cit.
[10] See Lester Taylor, Telecommunications Demand in Theory and Practice, Dordrecht, 1994, p. 265, p. 339.

19. Contrary to MCI's position, this outcome is not anti-competitive.[11] Because the BOC separate long distance subsidiary must buy access at the same price set by the Commission, as do the IXCs, no "anti-competitive" price squeeze can occur.[12] Indeed, the commission had ruled previously that a BOC Long Distance Affiliate must charge prices that exceed its own incremental costs of providing service.[13] These incremental costs will include the access charges paid by the BOC Long Distance Affiliate. Thus, no price squeeze can occur. Only when price is less than incremental cost is a price squeeze possible.[14] Thus, MCI's complaints that the BOCS will have an "artificial" or "unfair" advantage is incorrect because the BOC Long Distance affiliate will be able to charge lower prices than current prices for terminating traffic and still more than cover its incremental costs, including access charges.

20.Furthermore, access rates would exceed incremental costs in a competitive unregulated industry because of the large fixed costs of the network (imperfect competition). For instance, AT&T has publicly stated that its incremental cost for domestic calls is about 1 cent per minute (or less), so that even with 3-4 cents per minute of access, domestic long distance price are about 3 times incremental costs. Furthermore, it is Commission regulatory policy that sets access rates. I find it striking that MCI

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[11] MCI, Ex Parte Submission, July 20, 1998.

[12] Given the large margin of price over marginal (incremental) cost in international long distance, the possibility of a price squeeze is exceedingly remote, if not impossible. For a further discussion of regulatory rules in this situation, see Jerry Hausman and Tim Tardiff, "Efficient Local Exchange Competition," Antitrust Bulletin, 1995.

[13] "Non-Accounting Safeguards Order", ¶ 258; and "LEC Regulatory Treatment Order", ¶ 128. Similar arguments have been made previously by MCI and AT&T and the Commission has rejected them. See e.g. "Non-Accounting Safeguards Order", ¶ 258; and "LEC Regulatory Treatment Order", ¶¶ 125-130.

[14] Hausman and Tardiff, op. cit., discuss the relationship between imputation rules, such as the Commission's rules, and price squeezes.

recommends a policy that creates harm to consumers, giving as its reason that Commission policy will lead BOCs to lower international toll prices.

21. The "artificial advantage" that MCI complains of would not be anti-competitive even if the long distance affiliates of BOCs were legally permitted to establish prices for terminating long distance based on the ILEC's incremental cost of providing access, rather than the cost to the long distance affiliate of purchasing access. Indeed, it is pro-competitive because it will lead to lower international toll prices to consumers. The result would be lower prices for international services, based on the cost of providing the service, which does not "distort" competition at all. MCI claims that its profits will decrease, but it fails to realize that the public interest should be analyzed in terms of consumer welfare and economic efficiency, not the welfare of MCI Worldcom stockholders. This confusion between the welfare of consumers who benefit from lower prices and the welfare of MCI Worldcom stockholders should not cause the Commission to choose a policy which decreases economic efficiency and causes higher prices to consumers.

22. MCI and the other IXCs have a counterbalancing advantage to the ILECs in the current market situation. While ILECs have local access facilities, the IXCs have international transport and intercity facilities which are also priced above marginal (incremental) costs because of the fixed costs of their networks. To terminate international calls, each group must purchase services or lease facilities from the other

group. Increased competition from the ILECs will cause the IXCs to lower their prices toward their incremental costs and increase utilization of the IXC facilities.

23. MCI's conclusion, "On the other hand, the potential efficiency gains from such arrangements are very small, and the likely trickle down of these benefits to U.S. consumers even smaller or nonexistent" is incorrect.[15] Economic analysis demonstrates it to be wrong. Especially for international toll traffic to countries where competitive carriers exist, international toll prices may decrease more than costs decrease. For international toll traffic to countries where competition does not exist, the foreign carriers may capture a higher proportion of cost savings. Nevertheless, price will still decrease to U.S. consumers, which is a pro-competitive outcome.

III. Response to Dr. Lehr

24. Dr. William Lehr has submitted an affidavit on behalf of AT&T in which he opposes grooming by the BOCs. Dr. Lehr's basis for his main objection to grooming is "...to prevent the LECs from using their market power over local services and the revenues they receive from excessive access charges to subsidize their entry into international competition or to engage in anti-competitive activities aimed at raising rivals' costs." (p. 3) Dr. Lehr does no economic analysis to support his claims. I now demonstrate that he is incorrect.

[15] MCI's other argument that the ILECs will use grooming to foreclose CLEC competition is also incorrect. CLEC's entry decisions will not depend on their international toll revenues, given the very low percentage of traffic that international calls represent. MCI is making an "infant industry" argument that the Commission should decrease competition and favor CLECs. Consumers would end up paying higher prices so that MCI is asking the Commission to cause consumers to help fund CLEC entry through paying higher than competitive prices.

25. Economists have long agreed that a cross-subsidy exists only if a firm prices below its incremental cost, i.e. incurs a loss from offering the service. Dr. Lehr assumes that BOCs will take their incremental margin from access and use it in a loss making entry into international toll. Even if such a strategy were legal under existing regulation, Dr. Lehr fails to realize that such a strategy is economically irrational unless the BOCs could drive his client AT&T and other IXCs out of business. Otherwise, the BOCs are merely losing money and making their shareholders worse off with a cross-subsidy strategy. No company has an economic incentive to lose money for its shareholders. Thus, Dr. Lehr's claim of possible cross-subsidy (p. 10) makes no economic sense.

26. If the other IXCs exited the toll market, hypothetically a BOC could raise prices if the IXC did not re-enter. However, this possibility could not happen. First the BOCs have zero percent of the market while the latest FCC report places AT&T's share at over 65%.[16] Next, the costs of exit are high because the sunk costs of AT&T network cannot be re-used in another business without substantial additional investment. Furthermore, if an IXC did exit, the fiber would be sold to another company who could use it. Lastly, the margin of price over incremental cost for both domestic long distance for international toll is quite large, as I discussed above. For all of these reasons, no BOC could hope to drive the IXCs out of the market. Thus, they have no economic incentive to cross-subsidize their service.

[16] FCC Common Carrier Bureau, "Trends in the US International Telecommunications Industry", August 1998.

27. Dr. Lehr is incorrect for two further reasons here. First, the BOC affiliate that will sell international toll service will be a separate subsidiary that will not be price regulated. Instead, it will purchase long distance access service at the same prices as the IXCs. Second, long distance access prices are regulated by price caps so that no cost shifting can occur. Thus, the BOC affiliate's international toll service cannot be used to cause higher long distance access prices. The reasoning here is the same as in the Commission's dominance proceeding for BOC long distance services since the economic issues relating to possible cross-subsidy for international toll service are similar to the economic issues relating to interLATA toll service.

28. Prof. Lehr and AT&T are complaining about what they perceive to be excessive access charges. These charges are set by regulation by the Commission. The access rates are the same for domestic toll and for international toll calls. Presumably, the Commission has set the access rates in the public interest. The Commission has carefully set long distance access rates taking a number of economic and public interest factors into account. Dr. Lehr attempts to subvert economic analysis that leads to lower international toll prices to consumers because he claims that the markup of long distance access rates over their costs is "too high". Similarly, AT&T should not be permitted to cause international toll prices to remain higher than they would be with grooming because of a Commission rate setting decision. Consumers would be made worse off by such an action.

29. In terms of "raising rivals cost" mentioned by Dr. Lehr, I first consider the possibility of discrimination by the BOCs. Because access is regulated by the Commission, no potentially new problem arises here. The Commission considered these same possibilities in its dominance proceeding last year. The Commission decided that no new regulation was required. Since a BOC makes no distinction in its equal access transport between domestic and international toll calls, no new ability to discriminate arises here.

30. Dr. Lehr also states that grooming will distort the mix of traffic available to other carriers, and "may result in higher costs to other carriers" (p. 10). First, neither Dr. Lehr nor AT&T have done any analysis that demonstrates costs will increase to other carriers. But even if they did, the correct economic analysis is whether the overall costs to the US economy decrease. That is the main focus of productive economic efficiency that I discussed above. Grooming will lead to decreased overall cost so that productive economic efficiency will increase. Here is an example of Dr. Lehr's mistaken complaint. Suppose an oil delivery service in Boston charges the same price for heating oil for all deliveries that its makes. A competitor comes along and reduces price by 5% for heating oil deliveries near the oil import terminal because costs are lower for the shorter delivery distance. The dominant competitor, here AT&T, claims this is an unfair business practice because its costs have gone up since many customers have signed up with the new entrant because of the lower price. But the competition is pro-competitive, not anti-competitive as Dr. Lehr assumes.

31. The second problem with Dr. Lehr's claim is that "raising rivals costs" is only a problem if it causes price to increase. Here economic analysis demonstrates that prices will decrease with grooming. While Dr. Lehr characterizes this outcome as "cross-subsidy", I analyze it as reduced prices created by competition from new entrants into an oligopoly market, which results in greater efficiency and increased consumer welfare.

32. Moreover, even if ILECs do not carry outbound traffic initially, U.S. consumers will still benefit from these lower prices, especially if the foreign market has competition. Since the foreign carrier's costs will decrease with grooming, it will decrease its prices to callers in the foreign country. As economic analysis demonstrates, whenever costs decrease, even a monopolist finds it to be profit maximizing to reduce its price. These decreased prices will increase U.S.-bound call volume and reduce the traffic imbalance between the two countries, the underlying basis for the current "settlement deficits." Thus, Dr. Lehr's discussion (p. 10) of the outcome if ILECs do not carry outbound traffic is incorrect, because he fails to realize that the foreign carrier will increase its profits by decreasing its price when its costs decrease because of grooming.

33. Finally, there is no basis for Dr. Lehr's complaints about the effect of grooming on IXCs' settlement payments. First, assuming grooming will only apply to traffic outside the traditional settlements system, there are no "settlement payments" associated with this traffic or "settlement subsidy" that would be increased. While AT&T argues for a more limited lifting of the ISP than that proposed by the FCC, whatever the scope of the Commission's eventual reform, no economic basis exists for

treating grooming any different from the other arrangements that U.S. and foreign carriers will negotiate for the exchange of non-ISP traffic. [17]

34. Dr. Lehr's affidavit confuses consumer's interests and AT&T's stockholders interests. To paraphrase a famous remark made by a former Secretary of Commerce, Dr. Lehr seems to believe "What's good for AT&T is good for America". As Dr. Lehr states: "The US carrier with the largest share is likely to have more experience in negotiating with and operating in the foreign carrier's market and hence offer more effective competition than relatively new entrants that may be willing to negotiate less efficient settlements in order to purchase market share to penetrate a new foreign market." (p. 4) Thus, Dr. Lehr seems to believe that "new entrants" willing to negotiate less efficient settlements are bad for America because they "want to purchase market share." However, new entrants are good for consumers because they will offer lower prices to consumers. The current oligopoly situation where the big three IXCs have 97.6% market share with AT&T at 65% market share does not offer consumers the lower prices they will receive with BOC entry and lower prices due to the cost savings that will arise from grooming.[18] These reduced prices will reduce profits to AT&T and MCI Worldcom, but the Commission should see the public interest from the consumer viewpoint, not from AT&T's or MCI's viewpoint.

[17] AT&T, for example, would be free in such an environment to use its position as the U.S. carrier with the most extensive international and domestic long distance facilities and the largest share of U.S.-originated international traffic to negotiate favorable arrangements with foreign carriers. This could raise its rivals (including BOC LD Affiliates') costs in the same, but fundamentally economically incorrect, sense that Dr. Lehr asserts grooming would raise AT&T's costs.

[18] Share estimates from FCC Common Carrier Bureau, "Trends in the US International Telecommunications Industry", August 1998.

I hereby swear, under penalty of perjury, that the foregoing is true and correct, to the best of my knowledge and belief.

Oct 14, 1998

Jerry A. Hausman

Subscribed and sworn before this 14th day of October, 1998.

Lisa M Johnson

Notary Public

My commission expires:

3/11/05